



**SUPREME COURT OF THE UNITED STATES**

**OCTOBER TERM, 1942**

---

**No. 472**

---

**CLOVER SPLINT COAL CO., INC.,**

*Petitioner,*

*vs.*

**COMMISSIONER OF INTERNAL REVENUE.**

---

**PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS  
FOR THE THIRD CIRCUIT AND BRIEF IN SUP-  
PORT THEREOF.**

---

**ARTHUR S. DAYTON,  
W. W. BOOTH,**  
*Counsel for Petitioner.*



# INDEX.

## SUBJECT INDEX.

	Page
Petition for writ of certiorari.....	1
Opinions below (record).....	2
Jurisdiction.....	2
Statute involved.....	2
Statement of the case.....	4
Questions presented and errors urged.....	8
Reasons relied on for the allowance of the writ....	9
Brief in support of petition for writ of certiorari.....	13
Statement.....	13
Argument.....	13
Summary of argument.....	13
Issue under Sec. 26(c) (1) of the Revenue Act of 1936.....	15
Issue under Sec. 26(c) (2) of the Revenue Act of 1936.....	26
Conclusion.....	29

## TABLE OF CASES CITED.

<i>Commissioner v. Dashiell</i> (C. C. A. 7th), 100 Fed. (2d) 625.....	20
<i>Constantine v. United States</i> (C. C. A. 5th), 75 Fed. (2d) 928, affirmed 296 U. S. 287, 80 L. Ed. 233.....	25
<i>Farmers Loan and Trust Co. v. Minnesota</i> , 280 U. S. 204, 74 L. Ed. 371.....	25
<i>Gregory v. Helvering</i> , 293 U. S. 465, 79 L. Ed. 596.....	20
<i>Helvering v. Elkhorn Coal Co.</i> , (C. C. A. 4th) 95 Fed. (2d) 732.....	20
<i>Helvering v. Security Savings &amp; Commercial Bank</i> , (C. C. A. 4th) 72 Fed. (2d) 874.....	20
<i>Helvering v. Northwest Steel Rolling Mills</i> , 311 U. S. 46, 85 L. Ed. 29.....	8, 21
<i>Higgins v. Smith</i> , 308 U. S. 473, 84 L. Ed. 406.....	19
<i>Michigan Silica Company v. Commissioner</i> , (C. C. A. 6th), 124 Fed. (2d) 397, affirming 41 B. T. A. 511... 11, 15, 28	

	Page
<i>Old Colony Railroad Company v. Commissioner</i> , 284 U. S. 552, 76 L. Ed. 484 (560).....	22
<i>Saginaw and Manistee Lumber Co. v. Commissioner</i> , 45 B. T. A. 780.....	11, 29
<i>Shoenberg v. Commissioner</i> , (C. C. A. 8th) 77 Fed. (2d) 446.....	20

## STATUTE CITED.

Chapter 229, 43 Stat. 936, 28 U. S. C. A. 347.....	2
Revenue Act of 1936, Section 22(c).....	11
Revenue Act of 1936, Section 26(c) (1) and (c) (2)...	2, 3, 8, 9 11, 15

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

---

**No. 472**

---

CLOVER SPLINT COAL CO., INC.,

*vs.*

*Petitioner,*

COMMISSIONER OF INTERNAL REVENUE.

---

**PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS  
FOR THE THIRD CIRCUIT.**

---

*To the Honorables the Chief Justice and the Associate Jus-  
tices of the Supreme Court of the United States:*

Your petitioner, Clover Splint Coal Co., Inc., a corpora-  
tion, respectfully prays that a writ of certiorari issue to  
review the final order and decision of the United States Cir-  
cuit Court of Appeals for the Third Circuit, entered on the  
19th day of August, 1942, affirming an order of the United  
States Board of Tax Appeals, finding that there was a  
deficiency against this petitioner in income tax for the cal-

endar year 1937 in the amount of \$12,468.20. An order staying the mandate until October 31, 1942, has been entered by the Circuit Court of Appeals.

### **Opinions Below.**

(Record.)

There is presented with this petition a printed record consisting of the Appendix to the brief of the petitioner filed in the Court of Appeals and the proceedings in that Court. References to the record hereinafter set forth are to such printed record. The contents of the printed record were stipulated and agreed to by counsel, subject to the approval of the Court (R. 40), it being further stipulated that the entire transcript of the record in the office of the Clerk of the Court of Appeals should be filed in this Court, which was done, and that either party may refer to any portions of the certified transcript not included in the printed record accompanying this petition. The opinion of the Board of Tax Appeals appears in the printed record (pp. 24 to 29, incl.), preceded by findings of fact (pp. 15-23, incl.), and the opinion of the Circuit Court of Appeals (not yet officially reported) appears in the printed record (pp. 33 to 39, incl.).

### **Jurisdiction.**

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (Chap. 229, 43 Stat. 936, 28 U. S. C. A. 347).

### **Statute Involved.**

The issues involve the construction, and application to the facts in this case, of Section 26, Subdivisions (c)(1)

and (c) (2) of the Act of Congress, approved June 22, 1936, known as the Revenue Act of 1936, which are as follows:

“SEC. 26. CREDITS OF CORPORATIONS.

“In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

. . . . .

“(c) Contracts Restricting Payment of Dividends.

“(1) Prohibition on Payment of Dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

“(2) Disposition of Profits of Taxable Year.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to

pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

### **Statement of the Case.**

The material facts are summarized in the opinion of the Circuit Court of Appeals (R. 33-36), as well as somewhat more in detail in the findings of fact of the Board (R. 15-23). As stated by the court, there is no dispute of fact. In the proceeding before the Board, in addition to the issue here present, there was an issue with respect to depletion which was resolved for the most part in favor of the petitioner, and no appeal being taken by either party, that issue is not now before the court, the sole remaining issue being as to the so-called undistributed profits tax.

The Clover Splint Coal Company, Inc., a West Virginia corporation, the petitioner, which keeps its books in Pennsylvania, and accordingly filed its income tax returns with the Collector of the 23rd District of Pennsylvania within the Third Circuit, was engaged in the production and mining of coal from a leasehold in Kentucky. In 1929 it executed a mortgage to secure an issue of notes maturing May 1, 1936, the mortgage providing that the petitioner should deposit with the corporate trustee twenty cents for each ton of coal mined at such times as the aggregate of the outstanding notes should be less than \$300,000, twenty-five cents when the aggregate notes exceeded that sum. The mortgage was subsequently modified by three indentures, the last being on August 24, 1934, which modifications relieved the petitioner of some of its more immediate obligations under the mortgage, the net effect of the amendments being to extend the maturity of the notes to May 1, 1941, to relieve petitioner from making sinking fund payments for a period which expired on November 1, 1936, at which date sinking fund requirements became in full force



and effect and were in full force and effect throughout the year 1937. (See Statement of Facts in opinion below (R. 34-36).)

These modifications, all of which antedated May 1, 1936, were conditioned that the petitioner should make no payments in the nature of dividends except it should have previously paid to the Corporate Trustee an amount that would have been equal to the original sinking fund requirements, or should have acquired, by cancellation, mortgage notes in an equivalent amount, and were further conditioned that the petitioner should make no payments in the nature of dividends to its stockholders except that it should have previously paid all interest coupons.

It was conceded, and there is no dispute, that this was a valid restrictive contract inhibiting the payment of dividends until the conditions were met, and that it was in effect during the first ten months of 1937 (R. 36). Accordingly, at the commencement of the year 1937 petitioner was subject to three binding inhibitions or requirements under a valid restrictive contract antedating May 1, 1936:

(a) It was required currently to pay the Corporate Trustee twenty cents (twenty-five cents) for each net ton of coal mined.

(b) It was inhibited specifically from the payment of any dividend until it should have previously paid an amount equal to the original sinking fund requirements.

(c) It was specifically forbidden from making any payment of dividends except that it should have previously paid all interest coupons on the outstanding notes and interest upon the coupons as provided in the modified mortgage.

It is specifically stipulated (R. 11):

"At the commencement of the year 1937, and at all times prior thereto, and during said year until the

release of said mortgage, petitioner did not, and could not, make and did not have funds, or income, either accumulated or accrued, sufficient to make, the various payments required to be made by the various paper writings set out in subdivision (a) to (e) inclusive of this paragraph as a condition precedent to the payment of any dividends."

It is further stipulated (R. 11):

"All of the foregoing paper writings hereinbefore recited were executed and effective prior to the 1st day of May, 1936, and upon said day, and at all times thereafter, petitioner had not met, and was unable to meet the conditions therein set out, precedent to the payment of dividends."

For the year 1934, petitioner had a net loss of \$100,728.38; for 1935 it had a net loss of \$88,218.14; and for 1936 a net income of \$198.47 (R. 19). It is stipulated (R. 12) that on December 31, 1936, it had a deficit, in accordance with tax returns and adjustments made by the Commissioner, of \$435,614.86, and a deficit of \$372,958.36 on December 31, 1937. For the year 1937 its net income, exclusive of any allowance for depletion, was \$70,027.35, whereof \$49,611.46 was applicable to the period from January 1 to October 31, 1937, both inclusive, and \$20,415.89 to the last two months of the year. Its net income for 1937, after allowance for depletion as determined by the Board, was \$51,759.95 (R. 35). In 1937 its gross sales of coal amounted to \$1,014,098.24 (R. 19).

During the first ten months of 1937 it made payments in varying amounts to the Corporate Trustee in the aggregate of \$71,868.79, it being stipulated that such payments were made "as required by the mortgage" and the modifications thereof (R. 13). These payments were slightly more than its total net income for the whole year, exclusive of any

allowance for depletion, the latter being, as above set forth, \$70,027.35.

It is stated in the opinion of the court below that the petitioner has not shown, however, that the cash which it paid to the Trustee was actually the proceeds of earnings and profits. It is, of course, true that the earnings, as well as these payments, passed in the usual course of business through the credits and debits of banks, and neither in the payments, nor in the receipts of earnings and profits, was there a literal reduction to identical specie, but the court certainly does not mean that such would be necessary. It is most respectfully submitted that the court below, in stating that the sources of these payments has not been shown to be the proceeds or earnings or profits, has overlooked the stipulation not only that they were made "as required by the mortgage" (R. 13), but the language of the stipulation appearing on page 11 of the record, heretofore quoted, shows that until the release of the mortgage, petitioner did not, and could not make, did not have funds or income, either accumulated or accrued, sufficient to make, the various payments required. Such was intended to be, and is a comprehensive negation of the *existence* or *possibility* of any extraneous accumulated funds. It is stipulated that petitioner made these payments "as required by the mortgage," that is, the sinking fund provisions which were in full effect.

In addition to these sums so paid during the first ten months of the year there remained due as of November 1, 1937, under the mortgage as amended \$26,335.98, which sum was paid by the petitioner on October 20, 1937, to the Corporate Trustee, and the two said sums aggregating (together with a small balance in the hands of the Trustee) \$98,793.94 were disbursed in retirement of bonds and payment of interest (currently accrued and accrued in previous years), and the mortgage released on November 1, 1937

(R. 14). The mortgage was in full effect until November 1, 1937, and the payments aggregating \$98,164.77 were actually and irrevocably made prior to that date (R. 14).

Petitioner declared dividends attributable to that part of its net income received in the last two months of the year, but took the position that the part of its net income accrued and received during the first ten months of the year (having been irrevocably paid out as above set forth prior to the release of the mortgage, and the latter having inhibited the payment of dividends), was subject to a credit under both subdivisions of Section 26(c) of the Act. The Commissioner, denying this contention, imposed the undistributed profits tax upon the whole of the net income for the year 1937, without reference to that part accrued, received and paid out prior to the release of the mortgage, although conceding the effective character of the mortgage until it was released.

Before the Board, petitioner urged that the statutory law of West Virginia forbade the payment of dividends in case of a corporation having a deficit such as that here stipulated, and the unconstitutionality of the Undistributed Profits Tax Law, but in view of *Helvering v. Northwest Steel Rolling Mills*, 311 U. S. 46, decided after the institution of this proceeding, these contentions are no longer urged.

#### **Questions Presented and Errors Urged.**

(1) Whether or not petitioner is entitled to a credit under Section 26(c)(1) of the Revenue Act of 1936, with respect of income accruing, received and distributed to the Trustee within the first ten months of 1937, prior to the release of the mortgage, it being affirmatively stipulated that prior to such release petitioner was unable to meet the requirements of the mortgage, as amended, specifically made con-

ditions precedent to the declaration of dividends. The denial of such credit by the court below is urged as error.

(2) Whether or not petitioner is entitled to a credit under Section 26(c) (2) of the Revenue Act of 1936 for the amounts distributed during the first ten months of 1937, as required by the mortgage, it being petitioner's contention that such sinking fund provisions and other provisions of the modified mortgage, expressly dealt with earnings and profits for the taxable year. The denial of such credit by the court below is urged as error.

### **Reasons Relied On for the Allowance of the Writ.**

1. The Circuit Court of Appeals has decided an important question of Federal law which has not been, but should be, settled by this Court, in that—

(a) It has decided that the Undistributed Profits Tax Law is applicable to income for *all* of a taxable year, even though a valid restrictive contract be released during the year, and even though, prior to such release, income received has actually been irrevocably distributed, as required by such contract, upon a pre-existing debt.

(b) It has decided that for the purposes of the Undistributed Profits Tax the taxable year is an indivisible unit and that, even though a valid restrictive covenant be in effect during a portion of the year and income be distributed on prior debt, as required thereby, nevertheless, if such covenant be released in the course of the year, such release, in effect, is retroactive to the first of the taxable year, and, for purposes of undistributed profits tax, the status of all income for the year, even though actually distributed under the restrictive contract, is as though no restriction had been in effect.

(c) It has decided that the undistributed profits tax shall be based upon the net income at the end of the year, for the unit of the whole taxable year, arrived at as a matter of bookkeeping, rather than upon the actual status, ignoring the fact that a large part of the income in question has actually been distributed as required by a valid restrictive contract effective during a large part of the year.

(d) It has determined that the words of the statute "can be distributed" are to be interpreted from the viewpoint of the *book income* at the end of the year, ignoring that *actually* a large part of the income in question could not be distributed as dividends, because it had previously been distributed under a valid restrictive contract, which required such distribution, there being a stipulation that negatives the existence and possibility of extraneous income or accumulated funds from which such distributions, so required by the mortgage, could have been made.

The importance of this decision is apparent when it is noted that the same question is certainly involved in the case of every mortgage which requires, through sinking fund provisions or otherwise, the appropriation of current income to the satisfaction of prior secured debts and which mortgage is released during the current year. Generally, the question here involved affects every mortgage that was released or satisfied in a taxable year during the incidence of an undistributed profits tax, and affects the status of any distributions made in accordance with such mortgage. When it is noted that there were without question innumerable mortgages released or satisfied within taxable years during the incidence of the Undistributed Profits Tax Law, the wide effect of the decision below is seen.

2. The decision of the Circuit Court of Appeals is in substantial conflict with the decision of another Circuit Court of Appeals on the same matter, in that—

The mortgage here required a tonnage payment for each ton of coal mined. The Circuit Court of Appeals of the Third Circuit in the present instance has decided that such a provision does not deal with the disposition of earnings and profits within the meaning of Section 26(c)(2). The Circuit Court of Appeals of the Sixth Circuit, in *Michigan Silica Co. v. Commissioner*, 124 Fed. (2d) 397, affirming, per curiam, the Board of Tax Appeals in an opinion reported in 41 B.T.A. 511, held that a mortgage requiring a tonnage payment for each ton of product produced and sold dealt with earnings and profits. In the court below, it was sought to distinguish the *Michigan Silica Company* case on the ground that here the mortgage referred only to product mined, whereas there it dealt with the product produced and sold. It is submitted that such distinction is without substance. In any event, if coal were mined and unsold, certainly it would be required to be reflected in inventories, as otherwise true income could not be determined. (See Revenue Act of 1936, Section 22(c)). The sale of such coal would not affect taxable earnings or profits, if, as would be required, unsold coal were reflected in inventories. A sinking fund provision as to coal mined, disposes of earnings and profits as fully as though it specifically recited coal mined and sold. As a practical matter it could not be contemplated that a company would engage in current production without the sale of such current production, and in the present instance sales for the year in question exceeded one million dollars.

The Board in following the *Michigan Silica* case has not made this distinction, holding in *Saginaw & Manistee Lumber Co. v. Commissioner*, 45 B.T.A. 780, that a provision of a sinking fund for a unit payment of product sold or used was within Section 26(c)(2) of the Act, stating that although such payment was not specified to be made out of earnings and profits, it comes within the reasoning of the



*Michigan Silica* case. There is accordingly a substantial conflict between the decision of the Circuit Court of Appeals of the Third Circuit and the decision of the Circuit Court of Appeals of the Sixth Circuit.

WHEREFORE your petitioner respectfully prays that a writ of certiorari be issued out of, and under the seal of, this Honorable Court, directed to the Circuit Court of Appeals for the Third Circuit, commanding that court to certify and send to this Court for its review and determination, on a day certain to be therein named, a full and complete transcript of the record and all of the proceedings in the case numbered on its docket No. 8007, and entitled "*Clover Splint Coal Co., Inc., Petitioner, Appellant, v. Commissioner of Internal Revenue, Respondent, Appellee*", and that the judgment of the Circuit Court of Appeals for the Third Circuit entered on August 19, 1942, may be reversed and the decision of the Board of Tax Appeals entered on June 15, 1942, may be reversed and this petitioner held not liable for the tax in question and that this petitioner may have such other and further relief in the premises as to this Court may seem proper.

ARTHUR S. DAYTON,  
W. W. BOOTH,  
*Attorneys for Clover Splint  
Coal Co., Inc., Petitioner.*



